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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY,

Petitioner,

—v.—

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR PETITIONER

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I. *The Issues Respecting Premiums Deferred and Uncollected*

The Government does not deny:

1. That under any conventional test for the accrual of income, the "deferred and uncollected" premiums—which are not received or receivable—would not be included in income. —Rather, the Government appears to say that the "deferred and uncollected" premiums are not accruable under conventional tests, but because of certain deductions which the petitioner is allegedly taking it is only appropriate that the deferred and uncollected premiums be reflected in income even though conventionally they would not be (Br. Op. 9-10);

2. That the issues as to whether such amounts should be reflected in income and whether the loading on the

deferred and uncollected premiums should increase the assets of life insurance companies are issues which affect virtually all life insurance company taxpayers; that these are "industry-wide" issues under the Life Insurance Company Income Tax Act of 1959 (the "Act"); and that there is a mounting tide of litigation upon these issues (Pet. 24-27; Br. Op. 17);

3. That it is the general rule, rather than the exception, that all eleven taxable years which have been experienced commencing in 1958 under the Act are "open" for life insurance company taxpayers and involve these issues (Pet. 24-29; Br. Op. 17 n. 17); and

4. That even by the Government's own calculations—which contain a misuse of statistical method tending substantially to understate the amounts involved—there is some Seventy Million Dollars ($70,000,000) in back Federal income taxes which are dependent upon the resolution of these issues. (Br. Op. 17 n. 17)

Nonetheless, the Government opposes the grant of certiorari on these issues for a number of reasons, all of which are manifestly insubstantial:

1. On the merits, the Government appears at least in part to abandon the theory on which it managed to prevail in the Court of Appeals. —That theory was, in essence, that the position which petitioner contended for amounted to an attempt to take a deduction not provided for by law. Instead, the Government postulates a suspiciously new theory on which the judgment of the Court of Appeals might be sustained.

The new theory is apparently that because petitioner is allegedly permitted to take certain extraordinary de-

ductions, Congress has conditioned the taking of those deductions on the inclusion in petitioner's income of amounts not otherwise includible—the gross amount of premiums deferred and uncollected. Thus, the Government now argues "that Congress constitutionally may require the recognition of certain items of income as a condition for the allowance of deductions conferred as a matter of legislative grace." (Br. Op. 15)

But even if one were to grant, for the sake of argument, that Congress has the power to follow such an extraordinary course and to include the items in question in income, there is no evidence that it meant to do so here:

(a) In the first place, the statute is totally silent on the subject of including premiums deferred and uncollected in income. Had Congress decided to include these amounts in income, as part of the price for an unusually gracious allowance of a deduction, one would have thought that it would have left some hint in the statute that it was doing so. There is none. It is only when one reads the Treasury Regulations' crude rewriting of the statute (see Pet. 15) that one finds any reference to premiums deferred and uncollected. The Government's argument that the statute must have meant to include these fictional amounts—despite the silence of the statutory text and of the legislative history on this subject—is founded upon conclusionary phrases to the effect that "it must therefore be assumed that Congress was aware"[1] and to the effect that "the only logical in-

[1] What the Government hypothesizes that "Congress must have been aware" of is the "accounting practices used in the insurance industry" allegedly that the companies "accrue the full year's premium as of the anniversary date of each policy." (Br. Op. 10) However, if Congress was aware of this, it was also aware of the fact that under the industry's accounting practices, these assumptions do not enter into the calculation of gain from operations, because they are "wrung out" by the methods which we describe in the Petition for Certiorari. (Pet. 7-9)

ference is that Congress thought" that certain "assumptions" would be made in defining what "gross amount of premiums" meant when it used it in the statute. (Br. Op. 10) —It is, we submit, insupportable to infer that Congress exercised some power to require amounts not otherwise statutorily includible in income—or perhaps not even within the constitutional definition of income (Br. Op. 14-16)—to be included in income as a condition upon the taking of deductions, merely on the basis of *sub silentio* action.

(b) Moreover, the fact is that there are no extraordinary deductions upon the taking of which Congress might have conditioned the inclusion of these amounts in income. As we demonstrated in the Petition (pp. 7-9, and n. 9, p. 7), there are no "deductions" at all involved in the position we contend for. The net result of the computations which petitioner goes through in figuring its income on the NAIC form is that premiums deferred and uncollected are not reflected in income at all and no deduction whatsoever is effectively taken for the reserves applicable to the premiums deferred and uncollected.

The Government's keystone position on the inclusion of premiums deferred and uncollected in gain from operations turns on a plain misstatement of fact. The Government states that if the loading on premiums deferred and uncollected was not includible in income, there should also not be reflected in income the deduction for the increase in reserves attributable to the premiums deferred and uncollected. The Government suggests that the life insurance companies would not like this because it would increase the amount of their gain from operations. (Br. Op. 9)

The fact of the matter is, however, as we laboriously pointed out in the Petition (Pet. 7-9), that the effect of the calculations which petitioner goes through in computing its gain from operations is to put it in exactly the same position as if it had neither accrued any premiums deferred and uncollected or any of the related reserves.[2] As we pointed out in the Petition, the computations which petitioner is required to go through under the NAIC form in computing its gain from operations "match" the gross premium deferred and uncollected against the "loading" on it and the reserves in respect of it. By definition, the re-

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[2] The Government has furnished a clear indication of the precise nature of its fallacy. It states: "Indeed the effect of petitioner's claimed offset would be to defer tax indefinitely on part of its first year's profit on policies having deferred premiums. In the first policy year petitioner would take deductions for [1] all expenses incurred during the taxable year, [2] a full year's reserve on the policy, and [3] the loading deduction claimed here." (Br. Op. 11)— But all that petitioner wants to do in fact is to take deductions for the expenses actually incurred and the reserves attributable to premiums actually received, and to take into income the premiums actually received.

The Government is guilty of a misstatement when it claims that petitioner is really trying to take a deduction for alleged item (2)—"a full year's reserve on the policy." Petitioner does not take a deduction for a full year's reserve on the policy because, to the extent that the reserve is in respect of premiums deferred and uncollected, under the NAIC form petitioner "wrings" out of the income statement these reserve liabilities by including an offsetting factor against them—the net valuation premium on the premiums deferred and collected (Pet. 7). Nor does petitioner take a deduction for item (3); petitioner has not received the loading nor has it any right to receive it; it simply does not include the loading in income. The horror suggested in the rest of this paragraph of the Government's brief, that petitioner is contending for an indefinite deferral of income, can, accordingly, be dismissed. All that happens under petitioner's method of keeping its accounts—which accords in result, with respect to gain from operations, with settled principles of tax-accrual accounting—is that it does not reflect in income ("gain from operations") the premiums and the related reserve liabilities until the premiums are actually received or there is a right to receive them.

serves and the loading together make up the gross amount of the premiums deferred and uncollected. The computations, by wringing out all three items—the gross premiums deferred and uncollected on the one side of the equation, and the components thereof, the reserves and the loading on the other, put petitioner's gain from operations on precisely the same footing as if the premiums deferred and uncollected had never entered into the computation at all. (See n. 6, pp. 9-10, *infra*.) As the Government appears to admit, this is precisely the result that would be obtained under "settled principles of tax accrual accounting."

The truth of the matter is that it is the Government, not the taxpayer, which is seeking to give effect, in the computation of gain from operations, to premiums deferred and uncollected. The petitioner's position is, and always has been, that these amounts and the related reserve increases should not be reflected by way of income or deduction in the computation of gain from operations.[3] Under petitioner's calculations, they are not reflected at all—positively or negatively—in that computation. —With respect to the computation of petitioner's assets (used for certain calculations under the Act, see Pet. 4 and n. 3), petitioner again simply follows the NAIC form—as it must under state law—which, to be sure, here takes into account reserve liabilities with respect to the premiums deferred and

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[3] The Government suggests that petitioner admitted in its brief in the Court of Appeals that the effect of the NAIC computations of gain from operations was different from that which would prevail under conventional principles of tax-accrual accounting, under which neither the reserves with respect to premiums deferred and uncollected nor the premiums deferred and uncollected would be taken into account. (Br. Op. 10) The pages cited by the Government may be searched in vain for any such concession, and petitioner of course has made none.

uncollected,[4] but which introduces an asset on the other side of the balance sheet—the premiums deferred and uncollected, net of loading—which exactly matches this liability. The extra amount the Government would add never appears in this NAIC-dictated computation at all. The Government would add this amount as an asset through pure fiat. The Government says that the reason why the NAIC form does not include the loading with respect to premiums deferred and uncollected is because that form is excessively concerned with solvency. See Br. Op. n. 6, pp. 6-7, pp. 12-13. But it is hardly excessively conservative for the NAIC form not to treat as an asset the loading on premiums deferred and uncollected amounts which, as of the balance sheet date, petitioner has not received and has no right to receive.

We know of no system of accounting that takes the apparent view of the Government that because these amounts are likely, someday, mostly, to be received they should be treated as an asset even though they are not received or receivable. The sole authority cited by the Government

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[4] Since these reserves are "required by law," the taxpayer must take them into account in the asset computations provided for the computation of its "taxable investment income." See §§ 801 (b)(2) and 804 of the Act.

The Government misstates the terms of the statute by stating (Br. Op. 3) that in "determining 'taxable investment income', the gross premiums are included in the company's 'assets', which control the fraction of investment income that is deemed 'taxable'."— The fact of the matter is that the statute never provides that gross premiums, or any kind of premiums, are to be considered "assets." See the provision as to assets, Section 805(b)(4) of the Act, Pet. App. 63a. In fact, the statutory provision does not substantially redefine the term "assets." It is hard to argue, as the Government must, from this "thin" statutory definition that the loading on premiums deferred and uncollected, amounts which the company has neither a right to receive nor has received, and which do not appear on its balance sheet, are to be considered "assets."

is a case which holds that accounts which had become receivable as of a year-end have to be taken into account by an accrual-basis taxpayer. *Charles C. Lewis Co.* v. *United States,* 14 F. Supp. 471, 473-74 (D. Mass. 1936). (Br. Op. 12) No one can quarrel with this elementary principle; the point is that the premiums deferred and uncollected here involved are by definition neither received nor receivable. As the Government itself observes (Br. Op. 3): "In calculating 'gain from operations,' the gross premiums constitute part of the basic figure—*i.e.*, that comparable to 'gross receipts' or 'gross income'—from which 'gain from operations' is computed by subtracting statutorily defined deductions." But the short of our position is that when Congress used "gross premiums" in the statute, it meant it in the same sense as "gross receipts" or "gross income"—that is, the total amount received or receivable during the taxable year.[5]

2. Alternatively, the Government harkens back to the tactic which prevailed in the Court of Appeals, and misstates our position by claiming that we admit the inclusion of the amounts in question in income but then seek a deduction for the loading on the premiums deferred and uncollected on the ground that it is a proper estimate of future expenses. (Br. Op. 10-11) The Government then quite properly makes the point that there is no exact correlation between the "loading" on premiums deferred

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[5] Indeed, the Senate committee which reported on the Act indicated that the computation of gain from operations began with gross *receipts* and observed:

> "Gross receipts.— The first step is to determine *gross receipts. Gross receipts* for this purpose include *premiums and other considerations on insurance* and annuity contracts and also considerations for supplementary contracts." S. Rep. No. 291, 86 Cong., 1st Sess. (1959), 2 U.S. Code Cong. & Ad. News, at p. 1595 (emphasis supplied).

and uncollected and the ultimate expense and profit components that will be experienced when, as, and if the premiums in question are received. (Br. Op. 11)

The Government states that petitioner has made "repeated attempts to give the impression that the offset [*sic* —what is meant is the noninclusion of the premiums deferred and uncollected in income] it claims is but a reflection of items, like agents' commissions, that in any event would later become deductible." (Br. Op. 11) This may be an argument which the Government would have preferred that we had made, but we have not made it. The Government does not proffer any citation to the place in which we have made this argument; indeed, the District Court, at petitioner's request, found that the "loading" did not constitute an estimate of future expenses. (Pet. 39a)

The truth of the matter is that we are not claiming a deduction for future expenses at all, or, indeed, claiming any deduction with respect to the loading.[6] Our basic

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[6] What the "loading" "exactly balances," as we pointed out in the Petition, is not the anticipated future expenses—there is no necessary correlation between the loading and the anticipated future expenses—but the difference between the gross amount of premiums deferred and uncollected and the net valuation premium deferred and uncollected. (Pet. 7) Indeed, the District Court so found, and the Government's Brief in Opposition appears to accept this finding (Br. Op. 4); in fact, this is true by definition. (Pet. 7-8, n. 9) Since the net valuation premium deferred and uncollected and the loading thereon together exactly equal the gross premium deferred and uncollected, the effect of the three-stage calculation—(1) subtracting the increase in the net valuation premium (which is the same as the reserve increase) on the debit side, (2) adding the gross premium deferred and uncollected on the credit side, and (3) subtracting the increase in loading on the debit side—produces precisely the same result as if the whole subject of premiums deferred and uncollected had been ignored in the computation of gain from operations. The effect of the computations is simply to take one back to where one started from. It is unfortunate that the NAIC form introduces this complexity into the matter, as the writers which we have quoted in

position is, and has always been,[7] that the premiums deferred and uncollected should not be reflected in income at all until such time as they are received or there is a right to receive them, at which time they will, of course, by definition stop being "deferred and uncollected." Accordingly, it matters not whether the "loading" on the premiums deferred and uncollected will ultimately be allocated to expense or to profit. The short of the matter is that until the premiums in question are received or become receivable, the "loading" on them is not properly includible in income. When the premiums are received, then, and only

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the Petition have indicated (see n. 9, p. 8), but this long-standing peculiarity in accounting technique—which when followed through does produce the same accounting result as would obtain in an industrial corporation and under settled principles of tax accrual accounting—hardly seems a sufficient justification for the consequences which the Government would attach to it, namely, the unwarranted imposition of substantial additional taxes on the industry.

[7] The Government suggests that in the court below the position of petitioner was that the premiums deferred and uncollected were includible in income but a deduction should be allowed for the loading thereon. (Br. Op. 10) This is simply not so. The basic position of petitioner below was that the items in question did not constitute income to petitioner to be included in its statement of gain from operations. (See Plaintiff-Appellee's Brief, U. S. Court of Appeals, pp. 33-53.) The language from page 44 of that brief, quoted by the Government (Br. Op. 10), is simply from an alternative argument to the effect that if the premiums deferred and uncollected were to be included in income, a deduction should be allowed for the increase in loading. (See Pet. 17, n. 8.) Such an alternative approach was also suggested in the Court of Appeals as a method whereby that court could reach the correct result without necessarily invalidating the Government's regulation. However, contrary to the suggestion made here and elsewhere in the Government's brief (see Br. Op. 6) the petitioner is not accepting the regulation as valid; its basic position is, and always has been, that it is invalid.

Petitioner's primary position before the District Court was likewise that the items in question were not properly includible in income. The District Court's findings adopted this approach. (See Pet. App. 39a.)

then, should they be reflected in income, and if there are any proper expense deductions at that time, they will then also be taken. To the extent that the deductions then taken do not match the income reflected by the loading, there will, of course, be a net income on which petitioner will be taxable. Our position is not, once again, that the loading on premiums deferred and uncollected is a deduction. It is that premiums deferred and uncollected—in accordance with what the Government now appears to admit are conventional tax accounting principles—should not be recognized in income at all until they are received or become receivable. As we set forth in the Petition for Certiorari (pp. 7-9), the effect of the use of the NAIC form is not to recognize these amounts in income at all until the premiums are received or become receivable; the NAIC form is thus perfectly consistent in its outcome with conventional tax accounting principles.[8]

In aid of the Government's alternative position that what petitioner is trying to do is to take a deduction not provided by law, it blandly states (Br. Op. 6) that petitioner does

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[8] The weakness in the Government's position is best illustrated by n. 12, p. 14 of the Brief in Opposition, where it argues that because as a statistical matter petitioner eventually receives 95 to 98 percent of the deferred and uncollected premiums, it should accrue them forthwith. We had not previously heard it suggested that a taxpayer should be made to pay a tax in one year on what he was likely to receive the next year. The fact of the matter is that at the end of the first taxable year there is no right to receive the amounts in question and they have not been received. The fact that there is a statistical likelihood that petitioner will in fact receive the amounts in the second year is no reason for taxing them in the first; it will be time enough to tax them in the second.

It is obvious from this contention of the Government, and from the preceding discussion, that it is not petitioner who is claiming an adjustment to "indefinitely defer tax on part of petitioner's income" (Br. Op. 14), but rather that it is the Government's position that petitioner should indefinitely pay tax on amounts a year before they are received or there is any right to receive them.

not object to the inclusion in gross income of premiums deferred and uncollected. We cannot understand such a statement. The basic point of our Petition for Certiorari was to the effect that these items should not be reflected in income, and 26 pages of the petitioner's brief in the Court of Appeals were spent in argument under a caption that the pertinent amounts do "not constitute income to the plaintiff to be included in the statement of its gain from operations." See n. 7, p. 10, *supra*. —Of course, it is useful to the Government for purposes of argument to claim that there is no dispute as to inclusion in income and the real question is with respect to deductibility, but this is simply not the fact.

3. The Government next makes some effort to belittle the importance of the issues involved here by stating that it "believes" (Br. Op. 17) that we have "grossly exaggerated" the revenue consequences of the decision below. While we suppose the Government is entitled to its "beliefs," however unflattering they may be, nothing in the Brief in Opposition indicates any solid factual foundation for them. The Government's claims as to the dollar amounts involved appear to rest—to the extent that they do not rest on naked assertion—on a totally inadequate and misleading sampling of the industry. (Br. Op. 17 n. 17) The only figures which the Government has produced after four extensions of time, aggregating forty-seven extra days, in order to respond to the Petition[9] are based simply upon an examination of "the ten largest life insurance companies" in the United States. This is an absurdly

[9] These extensions were obtained by the Government in substantial part on representations that evaluation of the importance of the questions presented required the obtaining of data and information from the IRS. See letter dated December 23, 1968, from the Solicitor General to the Clerk.

narrowly based study, and its effect is grossly to overstate the amount of business in the life insurance industry done by the mutual companies.

As we pointed out in the Petition for Certiorari, the tax effect of one of the issues as to premiums deferred and uncollected is generally much more significant upon the stock insurers than upon the mutual insurers. (Pet. 21-22) While 90% of the life insurance companies in the United States are stock companies,[10] the mutual companies tend, generally speaking, to be the giants and to dominate the extreme upper end of a table of life insurance companies arranged by size. Thus, while mutual companies account for 70% of overall life-insurance-company assets and 54% of overall life insurance in force,[11] when one simply analyzes the ten largest companies in the United States, as the Government did, the ratios shift so that in the "top ten" the mutuals account for 85% of the assets and 80% of the life insurance in force.[12]

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[10] Institute of Life Insurance, *Life Insurance Fact Book* (1968), pp. 96-97.

[11] *Ibid.*

[12] In 1967, the ten largest life insurance companies in the United States accounted for $104,828,000,000 of assets, of which $90,402,000,000, or the 85% referred to in the text, was accounted for by the seven mutual companies in the top ten. In that year, the ten largest life insurance companies accounted for $561,659,000,000 in insurance in force, of which $447,774,000,000 was accounted for by the seven mutual companies, or the 80% referred to in the text.

Moreover, it is well known in the industry that the three stock companies which are in the top ten—Aetna, Connecticut General, and Travelers—write a very substantial amount of group business which is either formally participating or on which there are experience rating refunds or credits. In 1967, for the three, 86%, 69% and 75%, respectively, of premium income was from group business. *Best's Insurance Reports—Life-Health* (1968), pp. 7, 325, 1442. The result of this enormous writing of group coverage on a participating or similar basis is to create a tax profile for

The effect, then, of simply using this narrowly based selection—as opposed to the broader based samplings which we employed in the Petition (pp. 20-26)—is to exaggerate the impact of the mutual companies, to whom the issues as to premiums deferred and uncollected are somewhat less important, and thus understate the amounts of taxes involved. By using its narrow selection, the Government argues that the effect of the issues in question is only to alter the amount of taxes paid in the order of magnitude of 0.9%. On this basis, the Government concludes that the back taxes involved here are only $70,000,000. But for petitioner, a stock company, the effect of the inclusion of the additional taxes attributable to the Government's position on the issues in question for the years in suit here is to increase petitioner's taxes by 4.26%. If the Government's statistical sampling had been less biased against stock companies, we suggest that the average tax effect on an industry-wide basis of the Government's position might well have been, even as computed by the Government, in the area of an increase in taxes between 2% and 3%. Taking the Government's figures, this would mean that between $150,000,000 and $225,000,000 in

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these companies quite similar to that of a mutual company. Thus, by reason of the heavy tax deductions permitted to be taken in the computation of gain from operations, but not in the computation of taxable investment income, such companies may not have any significant excess of gain from operations over taxable investment income. See Pet. 21-22, and nn. 3 and 4, pp. 21-22. To the extent this is true, the effect of the Government's position that premiums deferred and uncollected should be reflected in gain from operations is nonexistent upon these companies. For these companies, the only effect of the Government's position is upon the asset computations used to allocate investment income between the taxable and the nontaxable shares. (Pet. 22-24)

Thus, the entire statistical "sampling" (if taking only the top ten out of 1700 can be called a "sample") employed by the Government is one which tends grossly to understate the industry-wide effect of the issues in question here.

back taxes would be involved in the issues in this case. While the Government had access—which, of course, the petitioner does not—to the tax returns of the industry, and while it obviously has made some use of them in preparing its Opposition, it is unfortunate it did not choose to analyze these returns on a broader basis.

In any event, it must be said, even on the basis which the Government has chosen to employ, there are admittedly Seventy Million Dollars in back taxes involved in the issues as to premiums deferred and uncollected. For the reasons we have indicated, the correct figures are probably much higher. But in any event, even taking the Government's word for it, there is an enormous amount of taxes involved with respect to these issues.[13]

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[13] As the Government points out, there is no conflict of appellate decisions on these issues. (Br. Op. 16) The decision below is the first appellate case on the subject. But obviously, despite the Government's efforts at a denial, there is a flat conflict between the decision below and the decision of the Tax Court in *Western National Life Insurance Co.*, 50 T.C. No. 28. See Pet. 18-20. The fact that the Tax Court in *Western National* not only rejected the Government's position, which the Court of Appeals in this case accepted, but went further than we contend for, hardly detracts from the fact that there is a conflict between the Tax Court and the Court of Appeals. The Tax Court's decision was apparently to the effect that in computing assets and liabilities, the taxpayer not only was not required to recognize as an asset the loading on premiums deferred and uncollected—which is our position—but that the taxpayer was not even required to recognize as an asset the "matching" amount, required by the NAIC form, for the premiums deferred and uncollected net of loading. It may be that this aspect of the Tax Court's decision turned on a procedural failure by the Government. In any event, our position does not go so far, but that does not mean there is no conflict.

The Government also points out that a Petition for Reconsideration is pending with respect to the Tax Court's *Western National* decision. This hardly negates the conflict. Indeed, that Petition has been pending undisposed of since last May. This does not suggest that, if left to their own devices, the lower courts will definitively resolve the issues involved here and will rapidly start closing the last eleven open years under the life insurance industry's Federal income tax returns.

4. Perhaps overcome by the size of the figures as to back taxes it is forced to admit to even under its own calculations, and by the lack of solid support for the decision below—and perhaps influenced by the fact that the issue in question affects virtually all life insurance companies and that in virtually every case all the taxable years back to 1958 have been kept open for these companies —the Government is forced into a strange admission.

That admission is that the Government would not have opposed certiorari if it appeared that granting certiorari "would facilitate the final settlement of the income tax liabilities of this and other life insurance companies." (Br. Op. 17-18) However, the Government somewhat remarkably claims that granting certiorari to resolve the issues involved here would delay the resolution of the tax liabilities of the life insurance industry generally. We find the reasoning hard to follow. The Government apparently is suggesting that if certiorari is granted, the lower courts and the tax authorities would abandon all efforts to resolve other issues which have been raised under the Act and spend their time waiting for this Court to resolve the issues at bar in this case.

The short answer is that it will obviously facilitate the overall settlement of the many open tax years of the members of the life insurance industry if this Court provides an authoritative settlement of the industry-wide issues involved here. One does not speed the resolution of all the open issues by putting off the resolution of issues as significant as the ones presented here.

We simply cannot understand how it can be contended that by leaving unresolved the important industry-wide issues here involved, it will somehow help in closing the many years which are open throughout the industry's

Federal tax returns. Taxpayers will continue to litigate the issues at bar here until they are authoritatively resolved. There is simply too much at stake for acquiescence by either side.

The Government does not take issue with the existence of the lengthy list of cases in court on this issue which we cited in our Petition (Pet. 27, n. 20)—24 in number—and it appears that there are hundreds of others at the administrative level.[14] Obviously, these issues should be resolved as promptly as possible. How denying certiorari here will assist in resolving some other issues—the Government, of course, does not say what they are or why they take precedence over the issues at bar—is obscure. Certainly denying certiorari here will not assist in resolving the issues at bar. Moreover, the Government's apparent suggestion that the Court should defer taking up the issues presented by our Petition until some sort of "supercase" is presented which poses not only them, but a number of other substantial issues to the industry, is not consistent, we suggest, with sound judicial administration either of this Court's docket or of the dockets of the lower courts.[15]

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[14] See the figures at Pet. 27-28. The Government, which should know, provides no statistics on the number of pending administrative cases.

[15] The Government claims (Br. Op. 18) that this is not a good case in which to grant certiorari because there was a finding below that the "loading" on premiums deferred and uncollected was not a reasonable estimate of future expenses. Indeed, as the Government points out, we do not contend that the loading is a reasonable estimate of future expenses; we submitted the finding in question to the District Court.

The Government seems to suggest that it would prefer that certiorari ultimately be granted in a case where the taxpayer was making the contention that the loading should be deductible as a reasonable estimate of future expenses. While we can understand the strategic considerations behind such a desire for a choice of opponents—it would be few taxpayers who would make such

II. *The Issues Respecting Unearned Interest on Policy Loans*

As to these issues, the Government does not deny that no other appellate opinion with respect to the deferral of income received but unearned sanctions a refusal to defer prepaid interest which is unearned and refundable. The Government's position on the merits on this issue is simply a stretching of the "receipt under claim of right" concept well beyond its established limits. We have discussed the merits of the question in the Petition (pp. 29-31), and little further discussion seems called for.

As we suggested in the Petition (p. 29), the Government's position is so extreme there is nothing in it to suggest that the receipt of proceeds of a loan by a taxpayer pursuant to an antecedent credit agreement would not constitute income. The loan proceeds would be received under a claim of right and without restriction as to their use. Under the Government's view, the fact that there is a corresponding liability to give the money back on the due date is evidently immaterial. But it is obviously absurd to treat the loan proceeds as income; the "receipt under claim of right" notion is not a shibboleth. As we

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an indefensible argument—we submit that the Government's preferences as to the choice of its opponents on this issue are not entitled to deference. The fact that the taxpayer here is not making the argument that the Government refers to hardly militates against the grant of certiorari.

We cannot help observing that the Government first belabors us for allegedly making the argument that the loading is a reflection of future expenses, and hence deductible (Br. Op. 11), and later (Br. Op. 18) belabors us for *not* making this argument, and for submitting a finding to the District Court that the loading on premiums deferred and uncollected is not an estimate of future expenses. Once again, it is not our position, or that of the *amicus*, that these amounts are deductible on this basis.

indicated in the Petition, with respect to prepaid interest, there is similarly a corresponding liability to give the interest back, and that liability only abates day by day as the interest is earned.

1. The Government contends that the issue is not of major significance to the life insurance industry. Once again, it follows the technique of pointing to just a few companies—the ten largest out of the approximately 1,700 in the industry. (Br. Op. 23 n. 22) According to the Government, only two out of these ten companies charged any significant interest in advance and the ten companies as a whole apparently only collected approximately $250,000 in advance interest per year; presumably it was only under a few types of policy forms that policy loan interest was charged in advance by these few companies.

But the practices of these ten companies are obviously too narrow a base from which to extrapolate any industry-wide figures for the entire industry of 1,700 companies. All the Government's figures tell us is that the policy forms used by the ten largest companies generally do not provide for charging interest in advance on policy loans. Our dollar analysis was based on a much broader sampling—the 100 largest companies—and reveals that these companies *themselves* showed in excess of $30,000,000 in unearned interest in a sample year and that, in extrapolating from them, the industry-wide figure was approximately $35,800,000 in the sample year.[16] Moreover, our question-

[16] The Government complains (Br. Op. 22-23) that our figure of $35,800,000 in annual unearned interest on policy loans contains an "inflationary element" because it includes, as well as policy loans, interest on premium notes and policy liens. Our Petition disclosed that these two other items were included, p. 11, n. 2, but pointed out that premium notes and policy liens are insignificant. Since the Government has seen fit to question this point,

naire analysis, which employed the responses from 169 companies, indicated that 73% had policies outstanding on which policy loan interest was charged in advance. (Pet. 34-35) This gives a different picture from the "top ten" which the Government cites.

With all deference to the Government, an issue can be very important to the 1,700 members of the industry even though it involves a sort of receipt of which the "top ten" giant companies do not have much. The fact remains that there is well in excess of $30,000,000 per year in unearned interest which under the Government's theory would be susceptible to taxation. The fact that this is concentrated in the companies which are somewhat smaller than the industry giants—the companies ranking from 11th through 100th—does not make the question any less important.[17]

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we have asked the American Life Convention to make an analysis, which discloses that, as of December 31, 1967, there was a total of $8,875,000,000 in policy loans among the assets of the 337 largest members of the life insurance industry, as compared to $11,383,000 in premium notes. ("Policy loans" and "premium notes" are each line items in the NAIC form statement of assets.) Only 39 of the companies had premium notes at all. Policy liens are an anachronism from the days when a number of companies were in rehabilitation proceedings, and there are so few these days that a line item is not even provided in the NAIC form for them. Accordingly, based on the comparison between the principal of policy loans and of premium notes, as indicated, it would appear that over 99.8% of the figure which we quoted in our Petition is, in fact, attributable to unearned interest on policy loans. The figure may be even higher, since it is difficult to imagine interest on premium notes being collected in advance. Accordingly, the Government's questions as to our figures are without merit.

[17] The distinction suggested by the Government between the practices of insurance companies and banks (Br. Op. 22 n. 21) does not appear to be well founded. As we developed in our Petition, it appears to be the practice of banks not simply to defer unearned interest income discounted in advance but that actually prepaid.

2. The Government seeks to rationalize the conflict of the decision below with the Seventh Circuit's decision in the *Artnell* case—which it nonetheless is quick to claim was wrongly decided[18]—on two grounds, neither of which has any merit.

(a) The Government points out that in *Artnell* there was not an absolute judgment for the taxpayer, but rather a remand to determine "whether the White Sox' method of accounting did clearly reflect its income."—The Tax Court in *Artnell* had embraced the Commissioner's *per se* rule that the income in question could not be deferred even though the taxpayer's accounting system might have properly reflected its income, and accordingly never made any finding on the issue as to whether the taxpayer's method accurately reflected its income. Hence the Court of Appeals ordered the remand.

But this does not distinguish the cases. Here there already has been a finding by the District Court that petitioner's method of accounting—day by day accrual of interest—does accurately reflect its income. (Pet. App. 49a) Of course, it is at least as clear that prepaid interest income is earned only each day as the interest period runs as that baseball season ticket revenues are earned only

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See Banking Law Journal, *Federal Income Taxation of Banks and Other Financial Institutions* (1968), ¶ 5.03(a). (Pet. 31) Moreover, the Government, embarrassed by the fact that the issue as to capitalized advance interest involves interest which has not in fact been received, proceeds to make the argument that it does not make any difference whether the amounts of advance interest have been physically received or not. (Br. Op. 19-20)

[18] During the time in which our Petition for Certiorari was pending, and the Government was considering its response, it obtained an extension of time within which to petition for certiorari in the *Artnell* case, but then chose not to file a petition for certiorari.

as each game is played. The basis on which the Court of Appeals reversed the District Court here was that, notwithstanding that the taxpayer's method of accounting did reflect its income, as a matter of law the income in question could not be deferred from the time it was received until it was earned. This is the very *per se* rule, contended for by the Government, which the panel rejected in *Artnell*.

The point of the two cases is that in *Artnell* the panel rejected the elevation of the "receipt under claim of right" doctrine to a *per se* rule notwithstanding the existence of a countervailing liability to give the money back. In the decision below, the panel embraced just such a *per se* rule.

(b) The Government also claims that the cases are distinguishable on "multiple bases". (Br. Op. 21) One basis is, it is said, that "this case does not involve dual taxpayers or a pretermitted taxable year". (Br. Op. 21) To be sure, it does not, but then nothing in the *Artnell* opinion indicates that this factor was of any decisional significance. Next it is said that "the contingencies that might cause restoration of the prepaid amounts are substantially different in nature" (Br. Op. 21); but to the extent they are, the factors are more favorable for deferral in our case.

Apparently in this connection, the Government seizes on what it calls the "peculiar fact" that the season ticket patrons in *Artnell* could secure refunds on future games "merely by demand." (Br. Op. 21) (We suppose, in addition, that the patrons would have to give their tickets back and thus relinquish their right to see the future games.) But this hardly distinguishes the cases. Here, by giving back the principal amounts they had borrowed, the

recipients of policy loans could get a refund, "merely by demand," on a per diem basis of their prepaid interest to the extent that it had not been earned. The cases are on all fours; in fact, we submit that ours is a clearer case for deferral of unearned amounts than *Artnell*.

While these issues do not have quite the enormous impact of the issues as to premiums deferred and uncollected, they are of very substantial importance to the life insurance industry. As we demonstrated in the Petition, controversies have arisen between the Government and many life insurance company taxpayers with respect to them. Our Petition reflects a broadly-based sampling of 169 life insurance companies—not just the ten selected by the Government. It indicates that 73% of the responding companies had policies outstanding on which policy loan interest was charged in advance, with 74% of these latter companies having already been challenged by the Internal Revenue Service. (Pet. 34-36)

We submit that the Government has not successfully challenged our estimate that approximately $35,800,000 annually in unearned prepaid interest is at issue, simply with respect to the additional investment income involved.[19] Indeed, even by the Government's calculations, there would be over $40,000,000 in back taxes involved on this issue for the industry's eleven open years. (Br. Op. 22) Finally, the holding of the Court of Appeals that, despite a precisely determinable obligation to make a refund of the advance unearned interest, deferral was not to be permitted, makes the decision below stand as the appellate

[19] In addition, of course, there would be a further effect on the taxes of the industry because of the inclusion of capitalized unearned prepaid interest in the assets of the companies, which would have the effect of increasing the "taxable share" of investment income.

decision rejecting deferral in the case most clearly calling for it. It is clear that there is confusion in the lower courts with respect to the application of the principles enunciated by this Court in the *Schlude* and *American Automobile Ass'n* cases which it would be appropriate for this Court to resolve at this time. These factors indicate that certiorari should be granted on these issues as well.

CONCLUSION

For the reasons stated in the Petition for Certiorari and herein, certiorari should be granted.

Respectfully submitted,

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